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Proposed statement of position : accounting by participating mortgage loan borrowers ;Accounting by participating mortgage loan borrowers; Exposure draft (American Institute of Certified Public Accountants), 1995, July 5

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

American Institute of Certified Public Accountants. Participating Mortgages Task Force

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING BY PARTICIPATING MORTGAGE LOAN BORROWERS

July 5, 1995

Prepared by the Task Force on Participating Mortgages
Accounting Standards Division
American Institute of Certified Public Accountants

Comments should be received by October 5, 1995, and addressed to
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July 5, 1995

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), *Accounting by Participating Mortgage Loan Borrowers*. This proposed SOP has been developed by the American Institute of Certified Public Accountants (AICPA) Participating Mortgages Task Force.

The purpose of this exposure draft is to solicit comments from preparers, auditors, and users of financial statements of borrowers in participating mortgage loan arrangements and other interested parties.

Comments on the exposure draft should be sent to Richard Stuart, Accounting Standards Division, File 4210.PM, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by October 5, 1995.

Comments will be reviewed by the task force to determine whether revisions should be made to the proposed SOP before it is sent to the Accounting Standards Executive Committee (AcSEC) for approval to issue a final SOP.

Written comments on the exposure draft will be available for public inspection at the AICPA library after November 5, 1995.

Yours truly,

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SUMMARY

This proposed statement of position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of that mortgaged real estate project, or both. This proposed SOP requires the following:

- At origination, the borrower should record the participating mortgage loan without allocating any of the proceeds to a liability related to the participation feature.

- At the end of each reporting period, a participation liability should be reported equal to the amount that would be required to extinguish the participation liability if (a) the participating mortgage loan matured or was refinanced at that date, or (b) the mortgaged property was sold at that date. When establishing or adjusting the participation liability, the corresponding charge or credit should be to debt discount.

- As estimates of the participation liability change because of changes in estimates of the market value of the property, the borrower should recalculate the effective interest rate to reflect the changes in expected future payments. The borrower should recalculate that rate assuming that (a) the amount of the expected future payment will be paid on the due date of the loan and (b) the recalculated expected future payment amount was known at the inception of the loan. The debt discount related to the participation liability should be adjusted, with a corresponding charge or credit to interest expense, to the amount that would have existed had the new effective interest rate been applied since the origination of the participating mortgage loan.

- Certain disclosures must be included in the financial statements.

This proposed SOP is effective for fiscal years beginning after June 15, 1996. Earlier application is encouraged. The effect of initially applying this proposed SOP should be reported in a manner similar to that of the cumulative effect of a change in accounting principle.

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PROPOSED STATEMENT OF POSITION

ACCOUNTING BY PARTICIPATING MORTGAGE LOAN BORROWERS

SCOPE

1. This proposed statement of position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of the mortgaged real estate project, or both. This proposed SOP applies to all borrowers in participating mortgage loan arrangements.

2. This proposed SOP does not apply to participating leases, financing arrangements not related to a real estate project, debt convertible at the option of the borrower into equity ownership of the property, or participating loans resulting from troubled debt restructurings. It also does not apply to creditors in participating mortgage loan arrangements.

BACKGROUND

3. Through the 1960s, most loans collateralized by real estate projects had fixed interest rates and long-term payment periods with full amortization of principal. Thereafter, loans with variable features such as adjustable interest rates and variable payments began to emerge. The desire for instruments in which the return to the lenders is tied more closely to the performance of the property led to the introduction of participating mortgage loans.

4. In a participating mortgage loan arrangement, the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of the mortgaged real estate project, or both. The terms and economics of participating mortgage loan agreements vary by agreement. The terms and economics of one agreement may create a circumstance in which any participation payment is remote. In another agreement, the terms and economics may transfer many of the risks and rewards of property ownership.

5. A lender may be entitled to participate in increases in the market value of a project either upon the sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. In agreements in which lenders participate in results of operations, the definition of the results of operations may vary among agreements. Examples of these definitions include but are not limited to revenue, income, or cash flows before or after debt service.

6. The participation terms of the mortgage loan agreement usually are negotiated concurrently with the other terms of the underlying mortgage loan. A borrower agrees to participation rights generally because of market conditions, or in exchange for concessions granted by the lender on some other term of the loan, such as a lower interest rate or a higher loan-to-value ratio.

7. In Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments*, the EITF considered indexed debt instruments, including participating mortgage obligations. The consensus indicates that the borrower's obligation under a participating mortgage to pay the lender a share of unrealized property appreciation should be recognized as a liability immediately when the property appreciates. A consensus was not reached, however, on how to account for the corresponding charge. AcSEC believes that additional guidance and clarification are needed that specifically address participating mortgage obligations in order to provide consistency in practice.

CONCLUSIONS

At Origination

8. At the origination of the participating mortgage loan (or upon introduction of a participation feature in connection with a loan restructuring other than a troubled debt restructuring) the borrower should record the loan without allocating any of the proceeds to a liability related to the participation feature.

Interest Costs

9. Interest expense in participating mortgage loans consists of the following three components:

- Amounts designated in the mortgage agreement as interest
- Amounts related to the lender's participation in operations
- Amounts related to the lender's participation in appreciation

10. *Amounts Designated in the Mortgage Agreement as Interest*. Amounts designated in the mortgage agreement as interest should be charged to income in the period that the interest costs are incurred.[1] If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate, or the U.S. Treasury bill weekly average rate), the calculation of the interest cost shall be based on the factor (the index or the rate) as it changes over the life of the loan. A change in the factor alone, however, without a related change in the market value of the mortgaged real estate project, does not require an adjustment similar to those described in paragraphs 12-13.

11. *Lender's Participation in the Results of the Operations of the Mortgaged Real Estate Project*. A lender's participation in the real estate project's results of operations (as defined in the participating mortgage loan agreement) should be recognized as interest expense in the borrower's corresponding financial reporting period.

12. *Lender's Participation in Increases in the Market Value of the Mortgaged Real Estate Project*. If the lender is entitled to participate in increases in the market value of the mortgaged real estate project, the borrower should estimate at each balance-sheet date the value on which the participation payment would be based. For example, if the borrower would be required to make a payment to the lender pursuant to the participation feature if the property were sold, the borrower should recognize a participation liability at the financial statement date equal to the estimated amount of the payment.

13. Each period, the participation liability should be debited or credited, if necessary, to adjust the balance in the account to the amount that would be paid to the lender if the property were sold at its then-estimated market value, or if the mortgage loan matured or was refinanced at that date. The corresponding debit or credit should be to the related debt discount account. When applying the interest method, the borrower should recalculate the effective interest rate to reflect the changes in expected future payments (exclusive of payments described in paragraph 11), assuming that (a) the expected future payment pursuant to the participation feature will be paid on the due date of the loan and (b) the recalculated expected future payment amount was known

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[1] Interest costs recognized pursuant to this SOP are subject to the requirements of FASB Statement No. 34, *Capitalization of Interest Costs*.

at the inception of the loan. The debt discount related to the participation liability should be adjusted to the amount that would have existed had the new effective interest rate been applied since the origination of the participating mortgage loan. In addition, there should be a corresponding charge or credit to interest expense for this cumulative interest adjustment.

14. If the participating mortgage loan is extinguished before its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss that should be reported as required by FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.*

Disclosures

15. The borrower's financial statements should disclose the following:

- The aggregate amount of participating mortgage obligations at the balance-sheet date with separate disclosure of the participation liabilities and related-debt discounts

- Terms of the participation by the lender in the appreciation of the property and the results of operations of the real estate project

- The amount by which the cumulative-interest adjustment exceeds the interest expense that would be determined by applying the recalculated effective interest rate to the obligation at the beginning of the period being reported upon

EFFECTIVE DATE AND TRANSITION

16. This proposed SOP is effective for financial statements issued for fiscal years beginning after June 15, 1996. The effect of the initial application of the provisions of this proposed SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle. Presentation of the pro forma effects of retroactive application is not required. Restatement of previously issued annual financial statements is not permitted.

17. Early adoption is encouraged but not required. If a decision is made to adopt the provisions of this proposed SOP before the fiscal year beginning after December 15, 1995 and the decision is made in other than the first interim period of the fiscal year, financial statements for previous interim periods of that year shall be restated.

18. The cumulative effect of adoption should be calculated using the rate in effect at the inception of the participating mortgage loan. For participating loans with variable interest rates, the initial rate should be treated as a fixed rate for purposes of this calculation.

DISCUSSION OF CONCLUSIONS

19. Participating mortgage loans and nonparticipating mortgage loans share the following characteristics:

- Debtor-creditor relationships between those who provide initial cash outlays and hold the mortgages and those who are obligated to make subsequent payments to the mortgage holders

- Real estate collateral

- Periodic fixed- or floating-rate interest payments

- Fixed maturity dates for stated principal amounts

20. Participating mortgage loans differ from nonparticipating mortgage loans because they have one or both of the following characteristics

- The lender shares in specified aspects of the results of operations, such as gross cash receipts or positive cash flows.

- The lender shares in increases in the market value of the mortgaged real estate. The participation payment is payable at one or more of the following times:

  - Maturity of the participating mortgage loan

  - Sale of the mortgaged real estate

  - Refinancing of the participating mortgage loan

  - Other dates specified in the participating mortgage loan agreement

21. Participating mortgage loans are complex packages of duties of the borrowers that can be divided into two categories: (a) those that are determined independently of the operation or appreciation of the mortgaged real estate, such as the repayment of loan principal or the payment of interest at a stated or floating rate, and (b) those based on the lender's participation in the operation or appreciation of the mortgaged real estate, or both.

22. Although nonparticipating mortgage loans also are characterized by interest payments at a stated or floating rate, such a rate in a participating mortgage loan is typically lower than in comparable nonparticipating mortgage loans. In addition, the loan-to-value ratios found in participating mortgage loans generally are higher than such ratios in nonparticipating mortgage loans. The potential value to the lender of the participation feature is expected to compensate the lender for accepting the lower contract interest rate, the higher loan-to-value ratio, or both.

23. The lender's participation reduces the borrower's potential realization of operating results or gain on the sale of the real estate. The participation, however, also reduces the borrower's risk of loss. The following are examples.

- The risk that the borrower will be unable to pay interest at the stated or floating rate in the loan agreement is less, because the interest rate generally is lower.

- The borrower has less capital at risk, because the loan-to-value ratio generally is higher.

Further, the obligation to pay the lender a share of the property appreciation does not increase the risk of loss to the borrower because the participation payments are made only if the market value of the property increases.

Interest Costs

24. *Amounts Designated in the Mortgage Agreement as Interest.* The periodic accrual of amounts designated in the mortgage loan agreement as interest at the effective interest rate is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 12, *Omnibus*

Opinion—1967.

25. *Lender's Participation in the Results of Operations of the Mortgaged Real Estate Project*. The conclusion in this proposed SOP that a participation by a lender in operations should be reported as interest expense of the period in which the corresponding operations occur is consistent with paragraph 86 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. The results of operations are known at the end of the period, so the amount owed to the lender can be determined, and the timing of the recognition of the expense is matched with the operations that result in the expense. The fact that the amount of the payment is based on operations does not change the character of the payment. The payment represents additional interest on a borrowing and should be included in interest expense.

26. *Lender's Participation in Increases in the Market Value of the Mortgaged Real Estate Project*. AcSEC considered several methods of recognition during its deliberations on accounting for lender participation in appreciation of the property. These methods are discussed in the following paragraphs.

27. Some members believe that the accounting for a lender's right to participate in the increases in the value of the property is addressed in APB Opinion 21. These members believe that, at the inception of the participating mortgage loan, the borrower should establish a participation liability equal to the fair value of the lender's right to participate in property value increases. They believe the liability should be offset by a debt discount, and that the discount should be amortized to interest expense by the interest method over the life of the loan instrument.

28. After inception, the participating mortgage would be accounted for using the established interest rate. The participation liability would be accounted for using either (a) a mark-to-market method or (b) a higher-of-cost-or-market method. Any changes to the participation liability resulting from changes in the market value of the property would result in adjustments to interest expense. This methodology, however, was not adopted due to concerns about the ability to separately price the right to participate in the increases in value.

29. Certain other members believe that any changes to the participation liability stemming from a change in the market value of the property should be offset by an increase in the reported amount of the asset. The increase in the carrying amount of the asset would be depreciated over the remaining useful life of the asset. Those members acknowledge that the resulting increase in depreciation expense results in the reporting of reduced earnings as the property appreciates in value, because the corresponding appreciation that is retained by the borrower is not reflected in the income of the borrower. AcSEC agreed that it was inappropriate to use an asset to account for changes in the market value of the property.

30. After consideration of the various alternatives, AcSEC determined that participating mortgage loan borrowers should account for lenders' appreciation rights by recognizing a participation liability and corresponding debt discount based on the market value of the property at each reporting date. Any changes in the participation liability account should be offset by changes in the debt discount account.

31. AcSEC considered several options concerning the timing and method of recognition of the changes in the debt discount account. One option considered was to recognize a liability for amounts that would be paid to the lender pursuant to the participation feature as if the property were sold for market value at each reporting date. Any change in the liability from one reporting date to the next would be charged or credited to income as an expense of that period. This method was rejected because the amount that would have to be paid to the lender to satisfy the

participation obligation is not necessarily equal to the recorded liability.

32. AcSEC agreed upon the cumulative interest adjustment approach, noting consistency with paragraph 73 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which states, in part:

> **Amortization based on Estimated Prepayment Patterns Adjusted for Changes in Estimates**
>
> The carrying amount of the loans at the [*reporting date*] ... is adjusted to the amount that would have existed had the new effective yield been applied since [*inception*].... Included in amortization [*at the reporting date*] ...is an adjustment for the difference in the prior effective yield and the new effective yield applied to amounts outstanding in [*prior*] years.... Amortization in [*subsequent*] years ...assumes the new estimates of [*property value*] ... occur as anticipated.

33. Establishing a debt discount to offset the participation liability will result in an effective interest rate that is higher than the stated or floating rate stipulated by the agreement. This practice is consistent with the following excerpts from paragraphs 7 and 11 of APB Opinion 21:

> A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate...
>
> If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given [*such*] accounting recognition.

34. Participating mortgages that call for lender participation in appreciation do <u>not</u> call for lender participation in decreases in the market value of the property below the defined value at the origination of the loan. Therefore, if the market value of the property declines to less than the market value as of the date of the participating mortgage loan agreement or a reference amount, the borrower would not recognize a participation asset.

35. A borrower may have a reduction in a participation liability in a depreciating real estate market. As shown in the example in appendix A, the borrower may record a decrease in the participation liability if the fair market value of the property decreases after an initial increase. As discussed in the preceding paragraph, however, the participation liability would not be reduced below zero.

APPENDIX A

EXAMPLE

Participation in operations and appreciation

Assume that Borrower Co. has purchased a property for $10 million. Borrower Co. has paid $1 million cash and entered into a participation mortgage loan agreement with Lender Co. in the amount of $9 million.

The loan agreement has the following terms:

- Fifteen-year term
- Interest-only periodic payments, principal to be repaid at end of term
- 5 percent interest rate
- 40 percent participation in appreciation above $10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced)

Other assumptions are as follows

- The property is appraised at the following values at the end of each of the next five years:

19X1	$11,000,000
19X2	$12,000,000
19X3	$11,500,000
19X4	$10,500,000
19X5	$11,000,000

- The cash outflows for interest payments in each of the next five years are $450,000 per year.

Based on the preceding assumptions, the following table summarizes the activity related to operations and appreciation for the years 19X1 to 19X5:

TABLE 1

	Year	19X1	19X2	19X3	19X4	19X5
A	Participation in Appreciation	$400,000	$800,000	$600,000	$200,000	$400,000
B	Int. Exp. Fixed	$450,000	$450,000	$450,000	$450,000	$450,000
C	Int. Exp. Part. in Appreciation	$ 18,256	$ 55,631	$ 12,050	($46,235)	$ 61,582

Calculations are as follows:

A: Participation in Appreciation
(Appraised property value at year end — acquisition cost of $10 million) X 40 percent participation percentage.

B: Interest Expense Fixed
Amount of loan ($9 million) multiplied by stated interest rate (5 percent)

C: Interest Expense Participation in Appreciation
See calculation below. Interest expense as calculated in following tables less $450,000 per year fixed interest.

The calculation of the interest expense - participation in appreciation is shown below:

Year 1 (19X1) — Effective interest rate is 5.2 percent (Note: For purposes of this example, the effective interest rates have been rounded). The effective rate is determined based upon an assumed principal due at the end of fifteen years of $9,400,000 ($9,000,000 loan amount plus 40 percent of $1,000,000 appreciation in year 1).

	Interest Expense (Loan Bal. X 5.2 percent)	Payment	Loan Balance
			$9,000,000
19X1	$468,256	$450,000	$9,018,256
19X2	$469,206	$450,000	$9,037,461
19X3	$479,205	$450,000	$9,057,666
19X4	$471,256	$450,000	$9,078,922
19X5	$472,362	$450,000	$9,101,284

Year 2 (19X2) - Effective interest rate is 5.4 percent

	Interest Expense (Loan Bal. X 5.4 percent)	Payment	Loan Balance
			$9,000,000
19X1	$485,973	$450,000	$9,035,973
19X2	$487,915	$450,000	$9,073,887
19X3	$489,962	$450,000	$9,113,850
19X4	$492,120	$450,000	$9,155,970
19X5	$494,394	$450,000	$9,200,364

At the end of 19X2, the borrower reassesses the fair value of the property. At this time, the participation liability is determined to be $800,000 ($2,000,000 appreciation to date multiplied by the 40 percent participation rate). As discussed in paragraph 13 of this proposed SOP, the liability is adjusted to the amount that it would have been had the new effective rate (5.4 percent) been in effect at the origination of the loan. At the end of 19X2, the loan balance would have been $9,073,887 had the 5.4 percent effective rate been used since inception (see 19X2 loan balance column in the second table). Prior to any 19X2 entries, the loan balance is $9,018,256 (see 19X1 loan balance column in the first table). The interest expense adjustment, therefore, is $55,631 ($9,073,887 less X $9,018,256). Interest expense — participation in Appreciation for the remaining years is calculated in similar fashion.

The entries to record the activity would be as follows:

At the inception of loan/purchase of property

Land	$4,000,000	
Building	6,000,000	
Cash		1,000,000
Mortgage Loan Payable		9,000,000

To record purchase of property and related incurrence of debt.

At the end of 19X1

Loan discount—Part. Liab.(A)	$ 400,000	
Interest Expense (B)	468,256	
Loan discount—Part. Liab.(C)		18,256
Part. Liab.—Appreciation (A)		400,000
Interest Payable(D)		450,000

To record the participation liability related to lender's participation in the increase in the market value of the mortgaged real estate project. To record related debt discount and interest expense on the debt.

(A) Item A in Table 1
(B) Sum of items B and C in Table 1
(C) Item C in Table 1
(D) Item B in Table 1

At the end of 19X2

Loan discount—Part. Liab.(A)	$ 400,000	
Interest Expense(B)	505,631	
Part. Liab.—Appreciation (A)		400,000
Interest Payable(D)		450,000
Loan discount—Part. Liab. (C)		55,631

To record adjustment to participation liability related to lender's participation in the increase in the market value of the project. To record interest expense and liability related to lender's participation in the operations of the project.

(A) Cumulative participation from Item A in Table 1 of $800,000, minus opening balance of $400,000.
(B) Sum of Items B and C in Table 1
(C) Item C in Table 1
(D) Item B in Table 1

The journal entries for the next three years reflect the change in estimate of the participation liability and the resulting recalculation of the debt discount based on the revised effective rate.

At the end of 19X3

Interest Expense	$462,050	
Part. Liab.—Appreciation	200,000	
Interest Payable		450,000
Loan discount—Part. Liab.		200,000
Loan discount—Part. Liab.		12,050

At the end of 19X4

Interest Expense	$403,765	
Part. Liab.—Appreciation	400,000	
Loan discount—Part. Liab.	46,235	
Interest Payable		450,000
Loan discount—Part. Liab.		400,000

At the end of 19X5

Interest Expense	$511,582	
Loan discount—Part. Liab.	200,000	
Part. Liab.—Appreciation		200,000
Interest Payable		450,000
Loan discount—Part. Liab.		61,582

The balances of the relevant balance sheet accounts at the inception of the loan and at year-end dates are as follows (Note: The Net Liability balance consists of (1) the $9 million loan balance, plus (2) the participation in the appreciation, minus (3) the discount):

	1/1/x1	12/31/x1	12/31/x2	12/31/x3	12/31/x4	12/31/x5
Loan	$9,000,000	$9,000,000	$9,000,000	$9,000,000	$9,000,000	$9,000,000
Part. Liab. for Appr.	0	400,000	800,000	600,000	200,000	400,000
Discount	0	(381,744)	(726,113)	(514,063)	(160,298)	(298,716)
Net Liability	$9,000,000	$9,018,256	$9,073,887	$9,085,937	$9,039,702	$9,101,284